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BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission

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AZ CORP COMMISSION
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IN THE MATTER OF THE APPLICATION OF) DOCKET NO. W-03718A-09-0359
SAHUARITA WATER COMPANY, L.L.C.)
FOR RATE INCREASE.)

) SAHUARITA WATER COMPANY,
) L.L.C.'S EXCEPTIONS TO
) RECOMMENDED OPINION AND
) ORDER

Pursuant to A.A.C. R-14-3-110 (B), and the January 18, 2011 transmittal letter from the Commission's Executive Director, Sahuarita Water Company, LLC ("SWC") hereby submits its Exceptions to the January 18, 2011 Recommended Opinion and Order ("ROO") issued in the above-captioned and above-docketed proceeding.

I.

SUMMARY OF EXCEPTIONS

SWC's Exceptions to the ROO may be summarized as follows:

A. Ratemaking Recognition of Well #23

1. In connection with its conclusion that Well #23 is not "used and useful," and thus should not be recognized for ratemaking purposes, the ROO's adoption of Staff's methodology for determining water system adequacy carries forward the following deficiencies inherent in Staff's methodology as the same pertain to SWC's water system:

A) Staff's methodology relies on A.A.C. R18-5-503(A) and (B) for purposes of determining both storage and well capacity for Staff's system adequacy analysis.

1
2 Whereas, the language of the regulation(s) pertains only to determinations of minimum
3 storage capacity, and makes no reference to well capacity.

4 [i] In addition, in determining that amount of storage capacity
5 necessary for fire flow, Staff's analysis fails to take into account SWC's need to
6 provide independent fire flow storage capacity in the separate elevation zones on
7 its system pursuant to the International Fire Code.

8 B) Staff's methodology accords no recognition to the concept of "well
9 redundancy," which is a well-recognized and accepted engineering and design planning
10 concept in the water utility industry in the United States, in connection with the provision
11 for water system adequacy.

12 [i] Rather, Staff's methodology places undue reliance on storage
13 capacity as a supplement to that well capacity which Staff chooses to recognize.

14 C) Well #23 (i) is a result of SWC's ongoing planning process, (ii) was
15 constructed during the test period, and (iii) would have been placed into service during
16 the test period but for a directive from the Arizona Department of Environmental Quality
17 ("ADEQ") that such operation not commence until SWC's arsenic treatment plant was
18 ready for service.

19 D) Staff's methodology gives no consideration to the age and condition of the
20 wells upon which Staff relies for its system capacity analysis and conclusion. SWC's
21 Wells #14 and #18 are 40 and 35 years old, respectively; and, as a consequence, there is
22 an increased risk of casing failure, which typically entails 6-12 months outage for repair
23 or replacement. Further, Well #14 was out-of-service for 2 months in 2010, due to an
24 equipment failure; and, Well #23 replaced Well #14's production role during that period.

25 E) The fact that Staff has relied on the same system adequacy methodology
26 for 23 years is not dispositive of the question of whether such methodology is sound and
27 reflects current water utility industry engineering and design practices. In that regard,
28 Appendix "C" to SWC's September 14, 2010 Post-Hearing Initial Brief is a copy of a

1 letter from a Pima County Department of Environmental Quality representative observing
2 a "need" for the ADEQ regulations upon which Staff's methodology is predicated "to be
3 significantly revised to reflect water utility industry experience and current practices."
4 [emphasis added]

5 F) Continued ratemaking recognition of Staff's methodology creates a
6 proverbial "catch-22" dilemma for Arizona water utilities. Should they continue to
7 utilize current well-recognized and industry-accepted engineering and design concepts
8 for planning purposes, in order to insure their ability to provide ongoing adequate and
9 reliable service? Or, should they opt for minimal engineering and design criteria, in order
10 to insure ratemaking recognition of their investment in their next rate case?

11 **B. Ratemaking Recognition of Income Taxes.**

12 1. The ROO's denial of ratemaking recognition of income taxes as an operating
13 expense for LLCs and "S" corporations continues the current Commission policy on the subject.
14 That policy should be reconsidered and revised at this time, so as to accord ratemaking
15 recognition for LLCs and "S" corporations as well as "C" corporations.

16 2. The Commission's current policy appears to have two (2) underlying objectives.
17 The first objective, and in connection with the determination of a rate of return, is to examine a
18 "C" corporation from an after-tax perspective in order to be consistent with that entity vis-à-vis
19 the sample comparison companies which the Commission is utilizing. The second objective is to
20 avoid that cross-subsidization which could otherwise occur, if tax-reducing opportunities
21 available to other entities included within the "C" corporation's parent's consolidated return are
22 allowed to reduce the amount of income tax expense which should otherwise be recoverable
23 from the "C" corporation's ratepayers. In order to achieve these two (2) objectives, the
24 Commission has adopted the policy of treating regulating "C" corporations on a "stand-alone"
25 basis in order to determine income taxes for purposes of ratemaking.

26 A) More specifically, if the Commission authorizes an after-tax rate of return
27 for a "C" corporation, and a before-tax rate of return for an LLC or a "C" corporation, the
28 resulting value to an investor in the LLC or "S" corporation is going to be less, assuming

1 it otherwise represents the same investment risk as the "C" corporation. What is relevant
2 to investment risk in each instance is the cash flow available to the "C" corporation, LLC
3 or "S" corporation to pay dividends or make a distribution. By reason of the
4 Commission's current ratemaking policy, the LLC or "S" corporation has less cash flow
5 (than the "C" corporation) from which it can (i) pay dividends or make a distribution and
6 (ii) reinvest in plant and/or address unexpected changes in expenses.

7 B) In addition to the foregoing diminishment of investment value, the
8 Commission's current policy creates a situation where the LLC's or "S" corporation's
9 rates include no recovery of income taxes. In effect, this results in the LLC's or "S"
10 corporation's owners subsidizing what should be a ratepayer expense; and, thus it gives
11 rise to that very cross-subsidization which the Commission seeks to avoid.

12 C) Finally, it should be recognized that, under the Commission's current
13 policy, when a "C" corporation does not file its own income tax return, its taxable income
14 is in effect being "passed through" to the consolidated return of its parent. In essence,
15 this is no different than when the income of an LLC or an "S" corporation is "passed
16 through" to its owner or shareholder.

17 3. Accordingly, the Commission's current policy unfairly and irrationally
18 discriminates against owners of LLCs (such as SWC) and "S" corporations; and, it is in conflict
19 with the two (2) aforesaid ratemaking policy objectives.

20 4. A major premise underlying the Commission's current policy, and which the
21 ROO adopts, is a perceived distinction between the owners of "C" corporations vis-à-vis the
22 owners of LLCs and "S" corporations, respectively. More specifically, the former are perceived
23 as being subject to the prospect of "double taxation," since "C" corporations are taxable entities
24 under the Internal Revenue Code, as are the owners of "C" corporations, when dividends are
25 paid. Whereas, under the current rationale, since LLCs and "S" corporations are "pass through"
26 (or not taxable) entities, there are no income taxes paid at that level; and, the owners of such
27 entities are taxed only at their ownership level.
28

1 A) However, this "double taxation" risk concern is misplaced. More
2 specifically, the "C" corporation does not pay any tax on dividends which it may have
3 occasion to distribute. Rather, those taxes are paid by the shareholder or owner, which is
4 an exposure any shareholder or owner has with respect to his investment whether it be in
5 a "C" corporation, an LLC or "S" corporation. There is no "double taxation" burden
6 upon the "C" corporation itself.

7 B) Moreover, the "C" corporation's investors pay income taxes only upon
8 dividends actually received, not on the "C" corporation's income; and, the prospect of an
9 income tax on dividends usually is not a determining factor in the decision of the "C"
10 corporation as to whether to pay a dividend or in what amount.

11 C) Thus, the "double taxation" rationale should be recognized for what it is
12 not, and accordingly rejected at this time.

13 5. For the reasons indicated above, SWC submits the Commission's current policy
14 on this issue, which the ROO adopts, should be revised so as to allow ratemaking recognition of
15 income taxes on the income produced by "C" corporations, LLCs and "S" corporations from
16 their respective public service corporation activities, with the calculation of such income taxes to
17 be based on treating such entities as "stand-alone." It is time to end the unfair irrational and
18 discrimination which exists under the Commission's current policy on this subject.

19 C. **Ratemaking Recognition of "Non-Dedicated Employee" Salaries As An Operating**
20 **Expense.**

21 1. The ROO adopts the Staff's recommendation that no ratemaking recognition be
22 accorded to the salaries of "non-dedicated employees of Rancho Sahuarita Management, LLC
23 ("RSMC") who provided various services for SWC on a part-time basis during the test period
24 and preceding and subsequent years. The Staff argued, and the ROO concludes, that SWC failed
25 to discharge its burden of proof as to the specific nature of the services provided for the benefit
26 of SWC and its ratepayers by the "non-dedicated employees," and the specific amount of time
27 spent performing such services.
28

2. SWC acknowledged during the evidentiary hearing, and acknowledges in these Exceptions, that SWC could and should have maintained better records of the nature here in question. This represented SWC's first rate case since its current rates were authorized, and SWC did not fully appreciate the necessity for such records. Suffice it to say, this has been a "painful learning experience" for SWC.

3. However, despite acknowledging testimony by Staff witness Jeffrey Michlik that the "non-dedicated employees" had provided some (albeit unquantified) "value" to the operations of SWC during the test period, the ROO provides for absolutely no ratemaking recognition of that value.

A) SWC respectfully submits that this approach is arbitrary and unduly punitive.

B) Moreover, the evidentiary record contains sufficient information from which it may be reasonably concluded that some of the services provided by "non-dedicated employees" were not duplicative of or overlapping with services provided by "dedicated employees." Examples include (i) the Chief Executive Officer services provided by Cort Chalfont for a portion of the test year in his capacity as President; (ii) the engineering and construction management services provided by Michael Bowman, since none of the "dedicated employees" possessed a background of that nature; and, (iii) financial planning and budget oversight services provided by Fred Lewis.

4. Against the above background, and on the basis of the evidentiary record, SWC submits that ratemaking recognition of at least fifty percent (50%) of the "non-dedicated employees" salaries which SWC originally proposed would be appropriate. SWC believes that this amount is supported by the evidentiary record; and, at the same time it represents an appropriate sanction for SWC's past deficient record keeping.

A) In that regard, SWC believes that the "cost-per-customer" analysis and cost comparison with other Arizona utilities data presented during the evidentiary hearing more than supports the reasonableness of this proposed level of ratemaking recognition.

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1 **D. Revision of Filing Date for Replacement Arizona Department of Water Resources**
2 **("ADWR") Best Management Practices ("BMP") 7.8.**

3 1. The ROO provides (i) SWC should submit a proposed replacement for BMP 7.8,
4 which SWC has previously proposed for its system, in the event that ADWR does not formally
5 approve that particular BMP for SWC by June 30, 2011; and, (ii) such replacement should be
6 submitted for Commission consideration by SWC no later than September 30, 2011.

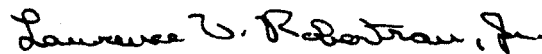
7 2. Given that (i) ADWR is not required to either approve or disapprove any BMPs
8 for SWC, since SWC as a "designated provider" and thus is not subject to ADWR's BMP
9 program; (ii) as a result of ADWR's recent reductions in staff personnel due to budget
10 constraints, there is no assurance ADWR would be in a position to act on the request for review
11 of BMP 7.8 or any subsequent replacement BMP suggested by SWC, if ADWR otherwise
12 inclined to act; and, (iii) SWC will need additional time to evaluate and select a suitable BMP,
13 SWC recommends that the aforesaid dates in the ROO be changed from June 1, 2011 to October
14 1, 2011, and from September 1, 2011 to January 1, 2012, respectively.

15 **II.**

16 **CONCLUSION**

17 For the reasons discussed in Section I above, SWC requests that the ROO issued on
18 January 18, 2011 in the above-captioned and above-docketed proceeding be revised as suggested
19 above by SWC.

20 Dated this 27th day of January 2011.

21
22 

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26 The original and thirteen (13) copies of the
27 above Exceptions will be filed on
28 the 27th day of January 2011 with:

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3 1200 West Washington
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5 A copy of the above Exceptions will
6 be emailed/mailed that same date to:

7 Jane L. Rodda, Administrative Law Judge
8 Hearing Division
9 Arizona Corporation Commission
10 400 West Congress, Suite 218
11 Tucson, Arizona 85701

12 Janice M. Alward, Chief Counsel
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